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AGENDA ITEM 10a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Currency Overlay External Managers – Annual Review

II. PROGRAM: Currency Overlay

III. RECOMMENDATION: Renew annual contracts of CalPERS' currency overlay managers, Pareto Partners and State Street Global Advisors, for a period of one year. Wilshire Associates' opinion letter is shown in Attachment 1. Wilshire Associates' disclosure letter is shown in Attachment 2.

IV. ANALYSIS:

Background:

The primary objective of CalPERS' currency overlay program is to provide risk control, or a reduction in the volatility of the returns from the CalPERS' international equity investments. The currency overlay program overlays approximately 25 percent of the CalPERS' international equity exposure.

On July 1, 1992 CalPERS initially funded two currency overlay managers, Pareto Partners (Pareto) and Credit Suisse Asset Management (CSAM). On June 12, 1996, after a subsequent Request for Proposal, CalPERS rehired Pareto and CSAM, and added State Street Global Advisors (SSgA), under one-year annual review contracts. The Investment Committee terminated CSAM's contract at its November 18, 2002 meeting. Yearly reviews of the performance of the CalPERS' currency overlay managers will be completed with a recommendation to the Committee to either renew or not renew each contract. Note that contracts have provisions for termination on 30-days notice.

As of September 30, 2005, Pareto overlaid 18% or $5.8 billion and SSgA overlaid 8% or $2.5 billion of the CalPERS' passive international equity assets, which are approximately 2/3 of total international equity assets.

Market Environment:

Uncertainty in late 2004 surrounding the U.S. elections, tighter monetary policy, and higher commodity prices ensured plenty of market volatility. Coupled with these uncertainties, the growing U.S. current account deficit drew close attention. Given this scenario, the dollar continued its slide, ending down almost 7.6% in the fourth quarter of 2004.

At the start of 2005, the foreign exchange markets quickly reversed course. In the first five trading days of 2005, the dollar rallied by almost 3.5%, causing a sharp loss of value added. Uncertainty related to the potential economic impact of Hurricane Katrina caused the dollar to re-weaken, once again reversing sharply once market participants determined the effects would be temporary. Another event introducing volatility into the FX markets was the expectation of a large revaluation of the Chinese Yuan. The subsequent small change of 2% was less than expected leading to yet another dollar rally. The dollar had a positive return in each quarter in 2005 of the review period, but did so in a volatile fashion.

The twelve month period ending September 30, 2005 was characterized by a choppy trading environment. There were multiple instances of well defined trends that ended abruptly with sharp reversals. This is one of the most difficult environments for the currency overlay managers. ***This was a critical component to external manager performance over the period – to reduce risk they had to forgo return.***

Performance:

As the primary goal of the program is risk reduction, the managers are compared to a fully hedged benchmark. This is an asymmetrical benchmark. Managers cannot be more than fully hedged.

In environments where foreign currencies strengthen against the U.S. dollar, managers can reduce hedges and add value. In environments where foreign currencies weaken against the U.S. dollar, managers can only hedge to 100%, thereby matching the benchmark.

Over the last year, environments have flipped back and forth. Over the period as a whole, foreign currencies were weaker. In a weaker currency environment, the best outcome is to be fully hedged. The best active managers could do was match the benchmark.

<u>Pareto:</u>
Pareto's risk control strategy attempts to capture at least 65% of any available upside from currency gains during periods when the U.S. dollar is decreasing in value relative to other currencies, while limiting any losses to three percent below

the fully hedged benchmark during periods of U.S. dollar strength. This is accomplished by employing a defensive strategy designed to forecast the risk of loss through currency risk modeling.

Over the twelve-month period ending September 30, 2005, Pareto has trailed the fully hedged benchmark (which is the actual currency exposure of the underlying portfolio, fully hedged) by -0.73%, returning -0.34% versus 0.39% for the benchmark. Over this same period, unhedged currencies returned -1.45%. Unhedged currency is tracked to gauge the opposite extreme. Pareto's performance fell between the fully hedged benchmark and unhedged. Pareto therefore fell within acceptable parameters.

Since inception in July 1992, Pareto has outperformed the fully hedged benchmark by 9.38% on a cumulative basis, returning 14.18% versus the benchmark return of 4.80%. Over this same period, unhedged currencies returned 3.84%. The comparison of unhedged to hedged benchmarks reflects the opportunity set the manager faces.

Pareto's performance is detailed in Table 1 below:

Table 1

Period	Pareto's Return	Fully Hedged Benchmark	Unhedged Currency Return
18 months ending 9/93	-1.51%	-3.58%	-0.39%
Year ending 9/94	1.36%	-0.37%	6.46%
Year ending 9/95	5.68%	1.33%	3.47%
Year ending 9/96	-0.17%	1.67%	-6.16%
Year ending 9/97	0.05%	1.65%	-7.00%
Year ending 9/98	0.26%	1.25%	-0.24%
Year ending 9/99	0.19%	1.71%	-0.08%
Year ending 9/00	-0.38%	2.55%	-11.10%
Year ending 9/01	0.66%	1.08%	-1.07%
Year ending 9/02	4.81%	-0.81%	5.54%
Year ending 9/03	1.56%	-1.04%	12.32%
Year ending 9/04	1.39%	-0.96%	5.89%
Year ending 9/05	-0.34%	0.39%	-1.45%
Cumulative from inception	14.18%	4.80%	3.84%

Pareto was unable to exceed their benchmark over the one-year review period due to the choppy trading environment. Pareto's risk controlled strategy focus is on the movement of the entire cycle, not a 1 year period. The since inception result in Table 1 encompasses periods of both dollar strength and dollar weakness. As evidenced from the since inception performance, Pareto has outperformed both the fully hedged and unhedged returns.

SSgA:
Similar to Pareto, SSgA employs a risk control strategy designed to capture 65% of any available upside to currency gains during positive return periods, while limiting any losses to three percent below the fully hedged benchmark during negative return periods. Their market philosophy incorporates fundamental and technical aspects. These differences diversify the portfolio due to the differing approaches of SSgA and Pareto.

SSgA's performance is detailed in Table 2 below:

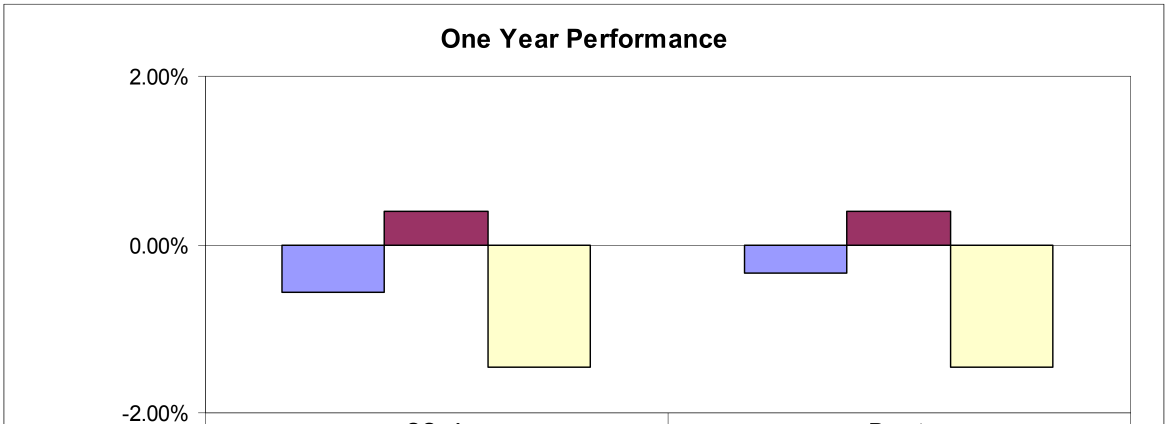
Table 2

Period	SSgA's Return	Fully Hedged Benchmark	Unhedged Currency Return
Year ending 9/97	0.48%	1.65%	-7.00%
Year ending 9/98	-1.24%	1.25%	-0.24%
Year ending 9/99	3.42%	1.71%	-0.08%
Year ending 9/00	-1.68%	2.55%	-11.10%
Year ending 9/01	2.26%	1.08%	-1.07%
Year ending 9/02	1.38%	-0.81%	5.54%
Year ending 9/03	1.23%	-1.04%	12.32%
Year ending 9/04	-1.54%	-0.96%	5.89%
Year ending 9/05	-0.57%	0.39%	-1.45%
Cumulative from inception	3.66%	5.90%	0.85%

The since inception result in Table 2 encompasses periods of both dollar strength and dollar weakness. Over the twelve-month period ending September 30, 2005, SSgA underperformed the fully hedged benchmark by -0.96%. SSgA returned -0.57% versus 0.39% for the fully hedged benchmark. On an unhedged basis the currency return was -1.45% over the same period. SSgA's performance was between the hedged benchmark and unhedged. Their performance therefore fell within acceptable parameters.

Since inception in October 1996, SSgA has underperformed the fully hedged benchmark by -2.24% on a cumulative basis, returning 3.66% versus 5.90% for the fully hedged benchmark. During this time period, the unhedged currency return was 0.85%. Note that SSgA has a different inception date than Pareto.

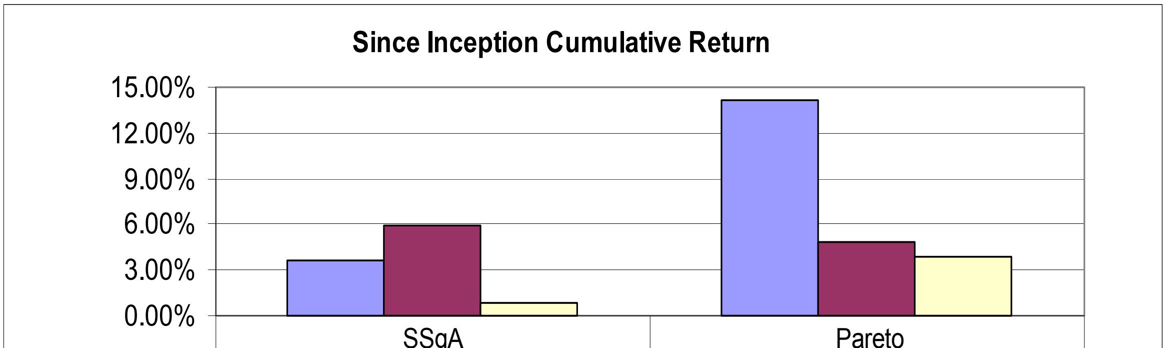
Comparable Performance of Managers
The graph and table on the following page summarizes performance for the currency overlay managers for the year ending September 30, 2005.



	SSgA	Pareto
Manager	-0.57%	-0.34%
Fully Hedged	0.39%	0.39%
Unhedged	-1.45%	-1.45%

From this graph it is evident that both Pareto and SSgA underperformed the fully hedged benchmark, but exceeded the unhedged result.

The following graph and table provides the since inception performance for each manager.



	SSgA	Pareto
Manager	3.66%	14.18%
Fully Hedged	5.90%	4.80%
Unhedged	0.85%	3.84%

Please note that the inception dates are different for the managers. The inception date of the SSgA currency overlay portfolio was October 1996, and Pareto's inception date is July 1992.

Staff and Wilshire recommend the Investment Committee renew Pareto's and SSgA's contract for a period of one year.

V. STRATEGIC PLAN:

Monitoring and review of the External Currency Overlay Program is consistent with Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The only costs associated with CalPERS external currency overlay program are the manager fees and staff time to monitor the managers. Returns shown in the agenda item are net of the manager's fees.

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